Department of Finance

News Release

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Government of Canada Announces Technical Amendments to Clarify the Specified Investment Flow-Through Entity Tax Rules

The Honourable Jim Flaherty, Minister of Finance, today announced proposed technical amendments to further clarify the tax rules that apply to specified investment flow-through entities (SIFTs).

The SIFT rules, enacted in June 2007, were part of the Government's October 31, 2006 Tax Fairness Plan. The Plan restored balance and fairness to the income tax system by reducing the tax differential between income trusts and corporations.

"Today's announcement will further clarify specific aspects of our Tax Fairness Plan and ensure the rules are applied properly," said Minister Flaherty. "These technical changes take into account constructive comments received from the public, helping to ensure that only the structures targeted by the Plan will be subject to the SIFT regime."

Among the proposed amendments is the removal of the distinction between Canadian and foreign real and immovable properties in determining whether a trust is a *real estate investment trust* (REIT). This will improve the international competitiveness of Canadian REITs.

Other SIFT taxation rules will be clarified through a number of technical amendments which in general terms will:

- make it easier for SIFTs, REITs and taxable Canadian corporations to own trust and partnership interests without causing those trusts and partnerships to be SIFTs;
- allow debt issued by a trust or partnership to be publicly-traded without causing the issuer to be a SIFT;
- allow a trust or partnership to hold a diversified portfolio of investments through one or more "portfolio investment entities" without causing the trust or partnership to be a SIFT;

- treat the equity securities of taxable entities that hold Canadian real, immovable or resource properties the same way as other equities;
- allow rent revenue of a subsidiary trust of a REIT to be qualified REIT revenue;
- clarify the acceptable short term investments of a REIT; and
- allow more flexibility in the use of REIT subsidiaries to hold properties.

The attached backgrounder describes the proposed amendments in detail. The proposed amendments will, as is the case with the existing rules, apply to taxation years that end after 2006 (with a delayed application, generally to 2011, for trusts and partnerships that existed on October 31, 2006). By announcing the amendments now, the Government is giving additional certainty to taxpayers who seek to apply the rules for the current taxation year.

The Minister also indicated that the Government remains committed to working with affected taxpayers to ensure that existing SIFTs can convert to taxable Canadian corporations without any undue tax consequences to investors, or the SIFTs themselves, on the conversion.

It is intended that the income tax legislation needed to give effect to today's announced amendments, and those that may be required for conversions, will be brought forward at the earliest opportunity in 2008.

This release was issued following the close of financial markets today.

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BACKGROUNDER*

PROPOSED TECHNICAL AMENDMENTS TO THE SPECIFIED INVESTMENT FLOW-THROUGH (SIFT) INCOME TAX RULES

Key Points

- The Government's 2006 Tax Fairness Plan implemented a taxation regime for "specified investment flow-through" entities (SIFTs) (commonly known as income trusts and publicly-traded partnerships). The rules treat SIFTs in much the same manner as corporations. SIFTs that existed on October 31, 2006, and that conform to published "normal growth guidelines", will become taxable under the new rules only starting in 2011.
- It is proposed that the SIFT taxation rules be clarified through a number of technical amendments. In general terms, these proposed technical amendments will:
    - Make it easier for SIFTs, real estate investment trusts (REITs) and taxable Canadian corporations to own trust and partnership interests without causing those trusts and partnerships to be SIFTs;
    - Allow debt issued by a trust or partnership to be publicly-traded without causing the issuer to be a SIFT;
    - Allow a trust or partnership to hold a diversified portfolio of investments through one or more "portfolio investment entities" without causing the trust or partnership to be a SIFT;
    - Treat the equity securities of taxable entities that hold Canadian real, immovable or resource properties the same way as other equities;
    - Treat real and immovable properties the same way under the real estate investment trusts (REIT) rules whether they are Canadian or foreign property;
    - Allow rent revenue of a subsidiary trust of a REIT to be qualified REIT revenue;
    - Clarify the acceptable short term investments of a REIT; and
    - Allow more flexibility in the use of REIT subsidiaries to hold properties.
- These measures will apply, if enacted as proposed, on the same timetable as the existing SIFT rules.

* Important Note: This backgrounder is a general, plain-language guide to legislative proposals that are inherently complex. While every effort has been made to ensure accuracy, this guide is neither a complete technical description nor an official interpretation of the subjects it discusses. The examples provided are simplified cases that are not intended to depict actual persons or transactions.

Specified Investment Flow Through (SIFT) Legislation

In 2006, the Government announced a new taxation regime for SIFT entities, commonly known as income trusts and partnerships. The new rules, which were enacted in 2007, tax certain income of a SIFT in substantially the same way it would be taxed if the SIFT were a corporation. Trusts and partnerships that would otherwise meet the SIFT definition and that existed on October 31, 2006 are exempted from this tax until 2011, as long as they do not grow in excess of specific guidelines set out by the Government.

Generally, a SIFT is a trust (other than a real estate investment trust, or REIT) or a partnership:

(a) that is resident in Canada ("*residence test*");

(b) investments in which are listed or traded on a stock exchange or other public market ("*public trading test*"); and

(c) that holds one or more non-portfolio properties (*"NPP test"*).

There are three types of non-portfolio properties:

(i) a security of a "subject entity", where the SIFT holds more than 10% of the fair market value of that entity (a Canadian-resident partnership, corporation or trust) or securities in the entity that collectively represent more than 50% of the value of the SIFT itself (*"concentration rules"*);

(ii) a Canadian real or resource property, if the fair market value of all of those properties held by the entity is greater than 50% of its value (*"cumulative rule"*); and

(iii) any property used by the SIFT in the course of carrying on a business in Canada ("*carrying on business rule*").

The Government proposes to clarify the scope of the SIFT legislation and refine further the requirements to qualify as a REIT.

Below are brief explanations of several key elements of the proposed amendments.

Subsidiary entities

The SIFT definition[1] will be amended to exclude trusts and partnerships whose equity (and equity-like debt[2], if any):

- is not publicly-traded, and
- is wholly owned by a SIFT[3], a REIT, a taxable Canadian corporation, another entity meeting this test, or any combination of these types of entities.

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[1] For simplicity, these notes refer to a single SIFT definition. Both the "SIFT trust" and "SIFT partnership" definitions are encompassed by this description.

[2] Equity characteristics generally include any right to convert the debt into equity, and participations of the kind described in the new definition of "participating debt interest" in *Income Tax Act* subsection 212(3). The rate of interest on an obligation will not by itself constitute an equity characteristic.

Example: Two publicly-traded corporations form a partnership to carry on a business venture. The public trading of the shares of the corporations will not cause the partnership to be considered a SIFT.

Example: A SIFT trust creates a wholly-owned trust to hold certain of its properties. The subsidiary trust will not be considered a SIFT.

Publicly-traded commercial debts

"Investments" in a trust or partnership include both equity and debt of the trust or partnership. Thus a trust or partnership may be a SIFT if its debt is publicly-traded, even if it has no publicly-traded equity.

The SIFT definition's *public trading test* will be amended to exclude publicly-traded debts that meet the following requirements:

- at least 90% of the fair market value of the debts are held by entities that are not affiliated with the trust or partnership; and
- none of the debts is equity-like debt.

Example: A Canadian corporation, a U.S. corporation and a pension fund form a partnership in Canada. The partnership issues "pure" debt on the public market. No more than 10% of the debt is held by entities affiliated with the partnership. The partnership will not meet the *public trading test*, and so will not be considered a SIFT, as long as it satisfies the above requirements.

Portfolio investment entities

A SIFT trust or partnership is a publicly-traded entity that owns one or more non-portfolio properties (NPP).

The *NPP test* in the SIFT definition will be modified, to exclude from the definition of non-portfolio property securities of a "portfolio investment entity". A new definition of "portfolio investment entity" will be introduced. A "portfolio investment entity" will be any entity that holds no non-portfolio properties.

Example: A publicly-traded trust holds as its only property a significant (more than 10%) interest in another trust. The other trust holds no non-portfolio properties. Under the current rule, the publicly-traded trust's investment in the other trust is a non-portfolio property, and the publicly-traded trust would be a SIFT. Under the new version of the *NPP test*, the investment in the other trust would not be a non-portfolio property, and the publicly-traded trust would not be a SIFT.

Definition "Canadian real, immovable or resource property"

Under the *cumulative rule* in the non-portfolio property definition, a Canadian real, immovable or resource property has been treated as a non-portfolio property of an entity

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[3] For this purpose, a SIFT includes a trust or partnership that would, but for the phase-in of the rules for entities that existed on October 31, 2006, be a SIFT trust or SIFT partnership.

if the fair market value of all Canadian real, immovable or resource property held by the entity is greater than 50% of the entity's equity value (a defined term). "Canadian real, immovable or resource property" includes shares of a corporation, and interests in a trust or partnership, if more than 50% of their fair market value is derived directly or indirectly from any combination of real or immovable properties situated in Canada, Canadian resource properties or timber resource properties, or other shares and interests that meet that test.

The definition "Canadian real, immovable or resource property" will be amended to exclude shares of taxable Canadian corporations and interests in SIFTs[4]. As a result, those shares and interests will not be included in applying the *cumulative rule* to determine if an entity holds non-portfolio property. It is important to note that the shares and interests may still be non-portfolio property under the *concentration rules* or the *carrying on business rule*.

Example: A publicly-traded trust invests exclusively in shares of resource companies, but it does not hold more than 10% of the fair market value of any of the resource companies, and none of the holdings represents more than 50% of the fair market value of the trust. Nor does it use those holdings in carrying on a business in Canada. Under the new rule none of the trust's holdings will be considered to be non-portfolio property, and it will not be a SIFT.

Real or immovable property of REITs

A REIT must currently hold real or immovable properties situated in Canada that (together with cash and certain debt securities) represent at least 75% of the equity value of the REIT. It must also derive at least 75% of its revenues from rent, mortgage interest and capital gains from Canadian real or immovable properties. As a result, REITs cannot own more than 25% of their assets in the form of foreign real properties and can have no more than 25% of their revenue from those properties.

The definition "real estate investment trust" will be amended to remove the distinction between Canadian and foreign properties. The 75% value and 75% revenue tests described above will continue to apply, but the geographic location of the real or immovable property will not be relevant.

Rent revenue from a subsidiary trust

As noted above, a REIT must, among other things, derive at least 75% of its revenue from rent from real estate, interest on real or immovable property mortgages, and capital gains from dispositions of such properties. If the trust holds real estate properties through a subsidiary trust, the income is not characterized as coming from real or immovable property, and therefore the income will not contribute to meeting the 75% revenue rule.

The REIT rules will be amended to clarify that revenue from real or immovable property will not lose its character simply because it is paid through an intermediary trust.

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[4] For purposes of applying this rule at any time in taxation years that end before 2011, a reference to a SIFT is only to a trust or partnership that is a SIFT (notwithstanding the provision of general transitional relief to 2011) at that time.

Example: A REIT holds real property through a subsidiary trust. The trust earns revenue in the form of rent, and pays that revenue (net of trust expenses) to the REIT. The REIT's revenue from the subsidiary trust will be counted towards both the 95% and 75% revenue tests that the REIT must meet.

Short term investments of REITs

A REIT must hold at least 75% of its equity value in any combination of certain qualifying assets – real or immovable property, cash or certain debt securities.

It was intended that "cash" be given a relatively broad reading in this context. To ensure that this objective is met, the list of qualifying assets in the definition "real estate investment trust" will be amended to include amounts on deposit with a financial institution and bankers' acceptances. Other highly liquid short term investments may also be included if a sufficiently precise definition can be developed.

Example: A REIT, having recently completed a financing transaction, places part of the cash in a bank account and another part in a short term GIC of a life insurance company, pending the acquisition of other real or immovable property. These placements (plus any accrued interest) will qualify for the 75% value test.

REIT-owned nominee corporations

A REIT may not hold non-portfolio property other than qualified REIT property. One type of qualified REIT property is securities of an entity (typically a "nominee" corporation) that holds only legal title to properties of the REIT (and ancillary property).

The definition "qualified REIT property" will be amended to allow a nominee corporation to hold legal title not only to real or immovable property of the REIT but also to real or immovable property held by another subsidiary of the REIT.

Example: A REIT holds a corporation and several subsidiary REITs. The corporation acts as trustee, holding legal ownership of all the properties for the subsidiary REITs. The new rules will allow the corporation to qualify as a nominee corporation, and thus its shares will be qualified REIT property of the parent REIT.

Next Steps

It is intended that legislation to implement these proposed changes will be brought forward at the earliest opportunity in 2008. The amendments will apply, if enacted as proposed, on the same timetable as the existing SIFT taxation rules.

For Additional Information

The Tax Fairness Plan is available on the Department of Finance website, at http://www.fin.gc.ca/news06/06-061e.html.

Information on pending legislation is available through the Parliament of Canada website, at

http://www.parl.gc.ca/LEGISINFO/index.asp?Language=e